

**Testimony of  
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**Before the House Subcommittee on General Farm Commodities and Risk Management  
Committee on Agriculture, U.S House of Representatives**

**March 3, 2005**

Good morning Chairman Moran, Ranking Member Etheridge and Members of the Committee. I am pleased to appear on behalf of the Commodity Futures Trading Commission (Commission or CFTC) to discuss the important issues surrounding the reauthorization of the Commission. Before I begin my testimony, I would like to recognize and introduce my fellow colleagues on the Commission, who join me here today. First is Commissioner Walt Lukken, who is certainly no stranger to many of you because of his years of experience working on the Hill. I had the pleasure of joining the Commission at the same time as Walt, and have greatly enjoyed working with him over the past two and a half years. As we proceed through the reauthorization process I look forward to drawing on his knowledge of the Commodity Exchange Act (Act).

I would also like to introduce the two newest members of the Commission—Commissioner Fred Hatfield and Commissioner Mike Dunn, both of whom I had the honor of swearing in this past December. In the short time that Commissioners Hatfield and Dunn have been at the Commission, they have contributed greatly to our efforts. I look forward to continuing to work with them and drawing on their considerable experience and insights. I have solicited input from all the Commissioners in preparing this testimony.

Finally, I would like to recognize and commend the staff of the CFTC. Having been on the staff of the agency during the early 1990's I was able to see firsthand the dedication they devote to the agency and industry they regulate. As the Acting Chairman I continue to see not only this dedication, but the enormous energy and creativity that they bring to their task. Without this energy and dedication, I am sure that much of the innovation that the Commodity Futures Modernization Act of 2000 (CFMA) enabled would not have been possible.

It was just over four years ago that Congress passed the CFMA. While this may seem like a short time, the amount of change that has occurred in the futures and derivatives industry over that period has been extraordinary. And much of that change has been facilitated by the flexibility and innovative foresight of that legislation. Today I would like to take the opportunity to brief you on the CFMA—the progress that the Commission has made in its implementation, what has worked well and what issues Congress may wish to consider during its deliberation on reauthorization this year.

Overall, the Act, as amended by the CFMA, functions exceptionally well. The CFMA has provided flexibility to the derivatives industry and legal certainty to much of the over-the-counter derivatives market. This flexibility has allowed the industry to innovate with respect to the design of contracts, the formation of trading platforms and the clearing of both on-exchange and off-exchange products. The industry is no longer overburdened with prescriptive legal

requirements and is able to operate using its best business judgment, rather than that of its regulator. At the same time, economic and financial integrity have been safeguarded and the Commission has been able to maintain its ability to take action against fraud and abuse in the markets it oversees.

Prior to the CFMA, the market was regulated with a one-size-fits-all model. It did not matter whether a customer was commercially sophisticated; whether the underlying commodity was susceptible to manipulation; whether a customer needed the flexibility of an over-the-counter contract or the liquidity of an exchange-traded one; or whether there was more than one way to deliver customer protections in the marketplace. This recognition by Congress of these differences represented a significant step forward in its design of the regulatory oversight structure. When Congress adopted the CFMA, it put in place a practical, principles-based model and gave the CFTC the tools to regulate markets that were challenged by competition brought about by technology and an increasingly global, marketplace.

Since the passage of the CFMA, the futures industry has experienced phenomenal growth and innovation. Between 2000 and 2004, the volume of futures and options contracts traded on U.S. exchanges has increased from 600 million contracts a year to over 1.6 billion contracts per year. The number of products traded on these exchanges has more than doubled from 266 to 556. Since enactment of the CFMA, eight new Designated Contract Markets have been approved by the CFTC, and 11 Exempt Commercial Markets and three Exempt Boards of Trade have filed notifications with the Commission.

The markets have also become more global. There is more access than ever for U.S. customers wanting to trade on foreign exchanges as well as for foreign customers wanting to trade in U.S. markets. Last fall, the CFTC approved a clearing link with a European futures exchange that allows U.S. customers of the foreign exchange to carry these positions at a U.S. clearinghouse. In short, the CFMA has permitted a level of innovation in these markets not seen since futures contracts were first traded in Chicago during the 19<sup>th</sup> century.

One of the benefits that has come about from this innovation has been increased competition and the lowering of trading costs. In response to the U.S. Futures Exchange's (USFE) proposal to list competing contracts, the Chicago Board of Trade (CBOT) dramatically reduced its execution fees on its market. In addition, the CBOT reacted to USFE by offering, for the first time, contracts based on German securities that were previously traded exclusively in Europe on Eurex.

New product and rule amendment certification procedures in the CFMA have also lowered regulatory barriers and fostered innovation by providing exchanges greater flexibility in listing contracts and reacting to developments in the cash markets. One result of the lowered barriers to entry is that different contract designs, such as binary options, have been offered as alternatives to using traditional futures and options. In short, the innovation, competition, and customer choice envisioned by Congress in passing the CFMA is bearing fruit.

That said, we at the Commission are committed to ensuring that our regulatory policies are similarly responsive and that the implementation of the CFMA fulfils the intent of Congress.

Competition and innovation must be realized in such a way that customer protection is not compromised and that the financial and economic integrity of our markets is preserved. In that regard, there remains more that we can do as a regulatory agency--working with industry and other domestic and foreign regulators--to move the ball forward even within the current statutory model.

As we begin the reauthorization process, any change should come with careful consideration of potential outcomes, as well as any unintended consequences that may present themselves. The Commission and its staff stand ready to assist you in any and every way possible as you consider possible actions at this time.

With that in mind, let me highlight three areas of concern on which Congress may wish to focus as it deliberates during the reauthorization process. First, Congress may wish to evaluate whether clarifications are necessary for the legal framework provided for exempt markets. Second, Congress may wish to suggest ways that we can more effectively avoid duplicative burdens on the markets and, going forward, provide us with guidance and support as we seek to work with other agencies and jurisdictions. Finally, we at the Commission are cognizant of Congress's firm commitment to ensuring that customers are protected from fraud and manipulation and, to that end, Congress may wish to review whether the CFTC has clear and adequate authority to police retail fraud, particularly in the foreign exchange area.

### Energy Markets

In the wake of the Enron collapse, and in response to recent run-ups in prices of natural gas and crude oil, there have been calls to increase the CFTC's regulatory authority in the energy sector. Some have called for retrenchment and a return to prescriptive forms of regulation like the adoptions of federally determined price limits and position limits. Others have called for more sweeping legislative changes that would give the Commission greater reach into proprietary and bilateral markets. As you consider the appropriateness of such proposals, I would ask that you keep in mind that the CFTC has responded decisively to prosecute wrongdoing in the energy markets.

The Commission has acted resolutely in the energy markets to preserve market integrity and protect market users, demonstrating that its authority is significant and that it intends to use it. I would note that the CFTC successfully pursued a complaint against Enron for attempted manipulation of the natural gas markets, and subsequently attained a civil monetary penalty of \$35 million. In addition, the Commission has filed and continues to pursue various actions and investigations in the energy sector against both companies and individuals. Our enforcement efforts thus far have resulted in the prosecution of 46 entities and individuals and the assessment of approximately \$300 million in penalties. In addition, the CFTC has recently promulgated regulations clarifying and detailing its authority regarding exempt markets, including certain energy transactions, to better ensure that these markets remain free from manipulation and fraud.

We are aware that last year's energy bill contained several provisions that would have directly affected the CFTC's oversight responsibilities, and we believe that it is appropriate and timely for our authorizing committees in Congress to consider and weigh in on these proposed changes.

The proposed changes sought to make it clear that the Commission has the authority to bring anti-fraud actions in off-exchange principal-to-principal transactions, such as those that occurred in the Enron Online-type of environment. While the CFMA provided for the Commission's fraud authority over exempt markets, some have questioned whether its application to bilateral and multilateral transactions would hold up given that our fundamental fraud authority appears to pertain only to intermediated transactions. It has been the Commission's contention that Congress intended to give the Commission fraud authority under the CFMA. Nonetheless, Congress may wish to provide us with additional guidance regarding this area of the Act.

The energy bill also contained savings clauses to confirm the Commission's exclusive jurisdiction with respect to futures and options on energy commodities, a provision to reaffirm the Commission's civil authority, and a provision affirming that these changes restate existing law and continue to apply to acts or omissions that occurred prior to enactment. Since these provisions of the energy bill amount to clarifications, Congress may wish to consider the necessity of these changes and its intent regarding Commission jurisdiction.

### Securities Futures Products

As you know, the CFMA was noteworthy, in part because of Congress's decision to permit the trading of futures on single securities, under the joint jurisdiction of the CFTC and the Securities and Exchange Commission (SEC). However, more than four years after the CFMA's passage, the growth of single-stock futures trading continues to be modest at best. In December 2004, the NQLX exchange, one of two exchanges that had been offering single stock futures, suspended trading.

It is of some concern that this sector has not been more successful and that despite the best efforts of the Commission, the CFTC and SEC have not fully achieved the goals of the CFMA. In particular, it is of concern that more progress has not been made with respect to implementing portfolio margining; that we have not avoided the double audit and review of notice registered exchanges and brokers; and that we have not determined the appropriate treatment of foreign security indices and foreign security futures products.

In many areas, however, I am pleased to say that the two agencies continue to work to establish regulatory approaches that avoid duplicative registration and regulation. Beginning in January, the staffs of the CFTC and SEC have been meeting to discuss a means whereby commodity pool operators, commodity trading advisors and hedge fund operators can be overseen without imposing duplicate regulatory structures. As we move forward, the agencies must take to heart Congress's instructions to avoid duplicative registration and regulatory requirements.

### Retail Forex Fraud

The CFMA clarified that the CFTC has jurisdiction over retail foreign currency futures and option contracts, whether transacted on exchanges or over-the-counter as long as they are not otherwise regulated by another agency. However, as demonstrated in the recent adverse

*Zelener*<sup>1</sup> decision, a case litigated by the Commission, the CFTC continues to face challenges to its jurisdiction based on how retail forex transactions are characterized. In this case and others, defendants often argue that transactions allowing retail customers to speculate on price fluctuations in foreign currency are not futures contracts, but spot or forward transactions outside the Commission's jurisdiction, including its fraud authority.

We at the Commission have been and remain committed to protecting retail consumers against the kind of egregious fraud that we see in the forex area. It has been the subject of much discussion within the industry and among the derivatives bar as to how to respond to the *Zelener* decision--whether we need additional authority or clarity in our jurisdiction, or whether we simply need to prove up our cases better. I would point out that our overall track record in the forex area is favorable. Since the passage of the CFMA, the Commission, on behalf of more than 20,000 customers, has filed 70 cases and prosecuted 267 companies and individuals for illegal activity in forex. As a result of those efforts, we have thus far imposed over \$240 million in penalties and restitution. Of the 70 cases that have been filed thus far, the Commission has lost only three.

### Conclusion

As noted, it has only been just over four years since Congress enacted, and the Commission began implementing, the CFMA. Given the progress made and the lessons learned, Congress may determine that it is premature to open the Act to significant changes. The Commission has been able to effectively work within the current structure of the Act to police markets, to ensure the integrity of the price discovery mechanism, to maintain the financial integrity of the markets and to protect customers. Nonetheless, the Commission stands ready to offer its assistance as Congress moves through the reauthorization process and considers a range of potential options.

In conclusion, let me say that my fellow Commissioners and I welcome this opportunity to work with you on the reauthorization of the CFTC. I greatly appreciate the opportunity to testify before you today on this important matter and would be pleased to answer any questions that the Committee may have.

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<sup>1</sup> See *CFTC v. Zelener*, 373 F.3d 861 (7<sup>th</sup> Cir. 2004), *reh'g and reh'g en banc denied* by 387 F.3d 724 (7<sup>th</sup> Cir. 2004).